

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Amish Patel, Individually and on
behalf of all others similarly situated,
Plaintiff,

vs.

Axesstel, Inc., H. Clark Hickock, and
Patrick Gray,
Defendant.

Case No.: 3:14-CV-1037-CAB-BGS

**ORDER DENYING MOTION TO
DISMISS**

On April 24, 2014, Jesse Cowan filed a putative class action complaint against Defendants Axesstel, Inc. (“Axesstel”), its former Chief Executive Officer (“CEO”), H. Clark Hickock, and its Chief Financial Officer (“CFO”) and current CEO, Patrick Gray, alleging violation of federal securities laws. The Court then granted an unopposed motion by Amish Patel for appointment as lead plaintiff and for approval of class counsel. On September 22, 2014, Patel filed an amended class action complaint against Defendants. Defendants have moved to dismiss the amended complaint. The motion has been fully briefed, and the Court determined that it was suitable for submission without oral argument. Because the amended complaint alleges facts that create a strong inference of scienter, the motion is **DENIED.**

1 **I. The Parties**

2 **A. The Plaintiff Class**

3 The putative class in this case consists of all purchasers of Axesstel stock
4 between February 28, 2013, to October 17, 2013 (the “Class Period”). [Doc. No.
5 13 at ¶ 1.] Lead Plaintiff Amish Patel and named plaintiff Jesse Cowan both
6 purchased Axesstel stock on several occasions during the Class Period. [*Id.* at ¶¶
7 22, 23.]

8 **B. Axesstel**

9 Defendant Axesstel is a Nevada corporation founded in 2000 with its
10 principal place of business in San Diego, California. [*Id.* at ¶¶ 24, 30.] As of the
11 end of 2012, Axesstel had a total of thirty-five full-time employees, only fifteen of
12 whom were located in the United States. [*Id.* at ¶ 35.] Of the thirty-five
13 employees, six were involved in executive, general and administrative functions,
14 three were involved in sales and marketing, and the remainder worked in product
15 development or operations. [*Id.*] Axesstel also had eight consultants, including
16 seven in sales and marketing, and one in product development. [*Id.*] In its 2012
17 Form 10-K filing with the Securities and Exchange Commission (the “SEC”),
18 Axesstel stated that it “has a small employee base and depend[s] substantially on
19 [its] current executive officers and key sales, engineering and operational
20 employees.” [*Id.* at ¶ 37.]

1 Axesstel provides various wireless and broadband products, including (1)
2 3G and 4G broadband gateway devices that can be used to provide wireless
3 broadband data to multiple computers on a network, (2) wireless desktop
4 telephones, and (3) wire-line replacement terminals that provide an alternative to a
5 traditional landline telephone network. [*Id.* at ¶ 30.] Axesstel sells and markets its
6 products worldwide. In the fourth quarter of 2012, Axesstel came out with a new
7 “Home Alert” product line that, once installed, automatically sends messages to
8 pre-assigned phone numbers or email addresses if the home or office is broken into
9 and a sensor is set off. [*Id.* at ¶ 31.] The Home Alert system was intended to be a
10 low cost alternative to traditional monitored alarm services because there is no
11 monthly monitoring fee. [*Id.* at ¶ 33.]

12 C. H. Clark Hickock

13 Hickock was Axesstel’s CEO from March 2008 through October 13, 2013,
14 and a director from March 2008 through October 17, 2013. [*Id.* at ¶ 25.] In
15 addition, in early June 2013, Hickock assumed the management responsibilities of
16 Axesstel’s Chief Marketing Officer, who resigned on June 7, 2013. [*Id.* at ¶ 38.]
17 Going forward, the sales executives for each of Axesstel’s four key regional
18 markets reported directly to Hickock. [*Id.*] When announcing this change on June
19 13, 2013, Axesstel explained that Hickock “has been increasingly active in key
20 customer relationships.” [*Id.*] Along these lines, Hickock spent four weeks in

1 Africa in early 2013 during which he had 13 customer meetings and met with a
2 logistics partner and local wireless operators. [*Id.* at ¶ 129.]

3 Hickock participated in the issuance of, signed, or certified as accurate
4 pursuant to a Sarbanes-Oxley Required Certification,¹ most or all of the alleged
5 false statements that form the basis of Plaintiffs' securities fraud claim, including
6 statements made in several of Axesstel's SEC filings during the Class Period. [*Id.*
7 at ¶ 26.]

8 **D. Patrick Gray**

9 Gray was Axesstel's CFO from February 2007 through the present, and has
10 also been CEO since October 13, 2013, following Hickock's termination. [*Id.* at ¶
11 27.] Prior to joining Axesstel, Gray held various finance and accounting positions

12 ¹ The amended complaint alleges that Hickock and Gray certified that they had
13 reviewed the respective filing and that:

14 2. Based on my knowledge, this report does not contain any
15 untrue statement of a material fact or omit to state a material
16 fact necessary to make the statements made, in light of the
circumstances under which such statements were made, not
misleading with respect to the period covered by this report;

17 3. Based on my knowledge, the financial statements, and other
18 financial information included in this report, fairly present in all
19 material respects the financial condition, results of operations
and cash flows of the Registrant as of, and for, the periods
presented in this report.

20 [Doc. No. 13 at ¶ 90.]

1 with other companies. [*Id.*] He has an M.B.A. and a B.S. in business
2 administration with a concentration in accounting. [*Id.*] Like Hickock, the
3 complaint alleges that Gray participated in the issuance of, signed, or certified as
4 accurate most or all of the alleged false statements that form the basis of Plaintiffs'
5 securities fraud claim, including statements made in several of Axesstel's SEC
6 filings during the Class Period.

7 **II. Factual and Procedural Background**

8 Over the course of its 88 pages, the amended complaint identifies a number
9 of allegedly false statements by Defendants during the Class Period. However, the
10 crux of Plaintiffs' securities fraud case is that (1) Axesstel improperly recognized
11 and reported revenue from purported sales of its Home Alert products to five
12 customers in Africa in the fourth quarter of 2012 and first quarter of 2013, and (2)
13 Axesstel misrepresented the collectability of the accounts receivable related to this
14 revenue. As discussed below, Axesstel's alleged false statements were made
15 primarily in its annual and quarterly SEC filings and related conference calls with
16 analysts and investors to discuss those filings.

17 **A. Axesstel's Revenue Recognition Policy**

18 The amended complaint alleges, among other things, that Axesstel violated
19 its own revenue recognition policy in connection with the revenue reported in its
20

1 SEC filings. That policy, as stated in several of the filings at issue here, includes
 2 the following:

3 Revenue from product sales is recognized when the risks of loss
 4 and title pass to the customer, as specified in (1) the respective
 5 sales agreements and (2) other revenue recognition criteria as
 6 prescribed by Staff Accounting Bulletin (“SAB”) No. 101
 (SAB 101), “Revenue Recognition in Financial Statements,” as
 amended by SAB No. 104, “Revenue Recognition.”

7 [*Id.* at ¶ 42.] The amended complaint also alleges some of the terms of the
 8 accounting bulletins referenced in Axesstel’s revenue recognition policy, which
 9 state that revenue is realized or realizable only when:

10 (a) “Persuasive evidence of an arrangement exists,” with the
 11 term “arrangement” meaning the final understanding between
 12 the parties as to the specific nature and terms of the agreed-
 upon transaction; (b) “Delivery has occurred or services have
 been rendered;” (c) “The seller’s price to the buyer is fixed or
 determinable;” and (d) “Collectability is reasonably assured.”

13 [*Id.* at ¶ 43. (quoting SAB 101(A)(1).] Further, the amended complaint alleges that
 14 SAB 104, Topic 13, 3(b) explains:

15 After delivery of a product or performance of a service, if
 16 uncertainty exists about customer acceptance, revenue should
 17 not be recognized until acceptance occurs. Customer
 18 acceptance provisions may be included in a contract, among
 19 other reasons, to enforce a customer’s rights to (1) test the
 20 delivered product . . . Accordingly, when such contractual
 customer acceptance provisions exist, the staff generally
 believes that the seller should not recognize revenue until
 customer acceptance occurs or the acceptance provisions lapse.

1 [Id. at ¶ 51.]

2 **B. February 28, 2013**

3 **1. SEC Filings**

4 The first set of Axesstel's alleged false statements occurred on February 28,
 5 2013, when it filed with the SEC its Fiscal Year 2012 ("FY 2012") Form 10-K, its
 6 FY 2012 Form 8-K, and a separate press release announcing its results that was
 7 attached to the Form 8-K (the "FY 2012 PR"). The 10-K was signed by Hickock
 8 and Gray, while the 8-K was signed by Gray alone. [Id. at ¶ 70.] These documents
 9 announced Axesstel's financial results for the fourth quarter ("Q4") of 2012, and
 10 for FY 2012 as a whole. To that end, Axesstel recognized a total of \$15.8 million
 11 in revenue in Q4 2012, which amount included \$3.5 million resulting from the
 12 purported sales of Home Alert products to two customers in South Africa in Q4
 13 2012. [Id. at ¶¶ 46, 75-76.] The sales to these two new customers were Axesstel's
 14 first reported sales of Home Alert products. [Id. at ¶¶ 78.b, 92.]

15 **2. Conference Call with Investors and Analysts**

16 Axesstel also held a conference call with investors and analysts on February
 17 28, 2013, to discuss its FY 2012 and Q4 2012 financial results. On this call,
 18 Hickock stated that in Q4 2012, Axesstel "launched our first entry level wireless
 19 Axesstel home alert security system. We recorded a total of \$3.5 million in
 20

1 revenue from two new customers in Africa, which is one of the developing markets
2 we've targeted for this product." [*Id.* at ¶ 93.]

3 On this call, when asked about the reception for the Home Alert product that
4 had already shipped, Hickock stated: "The reception has been fantastic. I mean
5 not only the ones what we just shipped to Africa, which are getting into the hands
6 of the guards now and the training is going on." [*Id.* at ¶ 127.]

7 C. May 14, 2013

8 1. SEC Filings

9 The second set of false statements occurred on May 14, 2013, when Axesstel
10 filed its Q1 2013 Forms 10-Q and 8-K, as well as a separate press release attached
11 to the Form 8-K (the "Q1 2013 PR"). The 10-Q was signed by Hickock, while the
12 8-K was signed by Gray. [*Id.* at ¶ 70.] In these documents, Axesstel announced
13 revenue of \$10.1 million during Q1 2013. [*Id.* at ¶ 80.] Of this \$10.1 million, \$4.0
14 million was for purported sales of Home Alert products to a total of three new
15 customers in South Africa and the Middle East. [*Id.* at ¶ 81.] Further, the Q1 2013
16 PR, which was attached to the 8-K form, stated that Axesstel "[s]old \$4.0 million
17 of new Home Alert systems in the first quarter of 2013 totaling \$7.5 million over
18 the past two quarters since the product release." [*Id.* at ¶ 96.]

19 In addition, Axesstel reported \$21.9 million in accounts receivable, which
20 amount included the \$3.5 million in purported Home Alert sales to the two

1 customers in South Africa from Q4 2012. [*Id.* at ¶ 80.c.] The Q1 2013 PR
2 contained a statement from Hickock explaining the rise in Axesstel’s accounts
3 receivable: “We also address a minor design issue in our newly-released Home
4 Alert security systems that caused a delay in collection of certain outstanding
5 accounts receivable as well as a slowdown in follow-on orders for those products.”
6 [*Id.* at ¶ 49.] Likewise, the Q1 2013 10-Q also explained that two “testing and
7 warranty events on [Axesstel’s] new phone and Home Alert products that caused a
8 delay in collection of our accounts receivables out of [Africa].” [*Id.* at ¶ 48.]

9 **2. Conference Call with Investors and Analysts**

10 Once again, Axesstel also held a conference call on May 14, 2013, with
11 investors and analysts to discuss its filings. On the call, Hickock discussed
12 Axesstel’s purported sales of Home Alert products, stating multiple times that
13 Axesstel sold over \$4 million in new Home Alert products to new customers in
14 Africa, noting that these sales “helped boost our gross margin to a record 29%.”
15 [*Id.* at ¶ 97.] Hickock further summarized that in “the first two quarters since its
16 release we have sold a total of \$7.5 million of our Alert devices to five new
17 customers in Africa.” [*Id.* at ¶ 97.]

D. August 13, 2013

1. SEC Filings

On August 13, 2013, Axesstel filed its Q2 2013 Forms 10-Q and 8-K with the SEC, as well as a separate press release attached to the Form 8-K (the “Q2 2013 PR”). The 10-Q was signed by Hickock, while the 8-K was signed by Gray. [*Id.* at ¶ 70.] The Form 10-Q reported Axesstel’s financial results for the first six months of 2013, including revenue of \$11.3 million and accounts receivable of \$15.1 million. [*Id.* at ¶ 85.] These figures included the \$4 million in revenue from purported sales of Home Alert products in Africa in the first quarter of 2013.

Meanwhile, in the Q2 2013 PR, Hickock addressed the steep drop in revenue during the second quarter, calling it a “perfect storm” that included a delay in the launch of new product lines and slow collection of receivables, but that “despite the launch delays, our new Home Alert products have generated opportunities that will be very significant if we can convert them to firm orders.” [*Id.* at ¶ 100.] Hickock went on to explain that “a minor warranty issue in the first quarter delayed the product launch in Africa. We corrected that issue in the second quarter. Those units are now being moved into the channel and are expected to launch during the third quarter.” [*Id.*]

Also in the Q2 2013 PR, Gray addressed the accounts receivable and Axesstel’s negative cash flow: “The reduction in cash is due in part to slow

1 collection of accounts receivable. . . . We finished the quarter with an account
2 receivable balance of \$15.2 million, of which \$12.2 million was past due. We
3 collected . . . an additional \$3.0 million to date in the third quarter. We expect to
4 collect the remaining receivables in the second half of 2013.” [*Id.*]

5 **2. Conference Call with Investors and Analysts**

6 As with the previous quarterly filings, Axesstel held a conference call with
7 investors and analysts on August 13, 2013. On this call, Gray again addressed the
8 accounts receivable, noting that \$12.2 million was past due as of June 30, 2013,
9 “so we took a real hard look at those past year receivables—and reserves where we
10 thought was appropriate and make sure, you know, based on our best estimate at
11 the time, that how we were reserving at an appropriate level in a level that we think
12 we can collect the remaining receivables without having to take any additional
13 reserves.” [*Id.* at ¶ 133.] When an analyst followed up on this issue, Gray
14 reiterated that aside from \$700,000 that Axesstel had reserved, it believed that the
15 remainder of the \$12.2 million was collectible. [*Id.* ¶ 134.]

16 **E. October 17, 2013**

17 On October 17, 2013, Axesstel filed a Form 8-K with the SEC stating that
18 Gray would be taking over the CEO position from Hickock, who had been
19 terminated. [*Id.* at ¶ 113.] Hickock also resigned as a board member effective
20 October 17, 2013. [*Id.*] The filing also addressed Axesstel’s accounts receivable,

1 stating that although it had collected \$4.0 million during the third quarter, \$9.0
2 million of the remaining \$11.1 million in accounts receivable were for sales to
3 customers in Africa. [*Id.*] The 8-K continued: “Those accounts are aging and we
4 are evaluating various alternatives for collection, including reserves against the
5 accounts or in some cases retaking possession of the product as inventory, and
6 attempting to resell the product to third parties.” [*Id.*]

7 **F. March 31, 2014**

8 On March 31, 2014, Axesstel filed another Form 8-K with the SEC. In
9 addition to reporting revenue of \$800,000 for Q4 2013, Axesstel explained that it
10 would be restating its financial statements for Q1 2013 which would result in a
11 \$3.9 million reduction in revenue for FY 2013. The filing continued:

12 On March 27, 2014, executive management of our Company
13 concluded that the previously issued unaudited financial
14 statements contained in our quarterly report on Form 10-Q for
15 the quarter ended March 31, 2013, and the two subsequent
16 unaudited quarterly reports on Form 10-Q in 2013 for the
17 periods ended June 30, 2013 and September 30, 2013
18 (collectively the “Prior Periods”), should no longer be relied
19 upon because of errors in those financial statements. The errors
20 relate to the recognition of revenue from sales to two customers
in the first quarter of 2013. In addition to the financial
statements of the Prior Periods, related press releases furnished
on current reports on Form 8-K, reports and stockholder
communications describing our financial statements for the
Prior Periods should no longer be relied upon.

The conclusion that the financial statements for the Prior
Periods cannot be relied upon is the result of an investigation . .

1 . commenced following the recent receipt of information that
2 revenue was recognized on two transactions prior to the
3 satisfaction of necessary criteria for revenue recognition. Our
4 policy is to recognize revenue from product sales when the
5 risks of loss and title pass to the customer, assuming all other
6 revenue recognition criteria are met. . . . For the two orders in
7 question, products were shipped and revenue recognized prior
8 to March 31, 2013, based on what certain of our sales
9 employees believed to be firm verbal commitments from two
10 customers in Africa. The products were never paid for by the
11 customers and in the fourth quarter of 2013, the products were
12 returned by the customers and the accounts receivable were
13 written off. However, our recent investigation revealed that
14 certain key aspects of the sales to these two customers were not
15 finalized at March 31, 2013, including payment terms and
16 marketing allowances. Therefore, the revenue associated with
17 these potential sales should never have been recognized.

18 . . .

19 We have considered the effect of the restatement on our prior
20 conclusions of the adequacy of our internal controls over
financial reporting at the end of each of the applicable
restatement periods. As a result of the errors described above,
management has concluded that the Company's internal control
over financial reporting were not effective to a reasonable
assurance as of the ends of each of the periods covered by the
restatement.

[*Id.* at ¶ 115.]

21 **G. May 21, 2014**

22 Axesstel filed another Form 8-K with the SEC on May 21, 2014. In this
23 filing, Axesstel stated preliminary unaudited financial results for FY 2013,
24 including revenues for the year totaling \$8.6 million, factoring in the \$3.9 million

1 reduction for the Home Alert revenue to Africa in Q1 2013. The filing also stated
 2 that “[i]n Africa, we had warranty issues which delayed the initial launch of the
 3 products, but ultimately our customers did not complete their purchases.” [*Id.* at ¶
 4 117.] In addition, Axesstel stated that its general and administrative expenses for
 5 2013 “included a \$3.3 million expense related to an account receivable reserve for
 6 accounts sold into Africa in the fourth quarter of 2012.” [*Id.*]

7 **III. Discussion**

8 Plaintiffs’ first claim is for violation of Rule 10b-5, enacted pursuant to
 9 Section 10(b) of the Securities Exchange Act of 1934. “Rule 10b–5 forbids,
 10 among other things, the making of any ‘untrue statement of a material fact’ or the
 11 omission of any material fact ‘necessary in order to make the statements made ...
 12 not misleading.’” *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (quoting
 13 17 CFR § 240.10b–5 (2004)). “The basic elements of a Rule 10b–5 claim . . . are:
 14 (1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection
 15 with the purchase or sale of a security, (4) transaction and loss causation, and (5)
 16 economic loss.” *In re Daou Sys., Inc.*, 411 F.3d 1006, 1014 (9th Cir. 2005) (citing
 17 *Dura Pharm.*, 544 U.S. at 341-42). In its motion, Axesstel argues only that the
 18 amended complaint does not adequately allege scienter.

1 **A. Pleading Standards for Scienter Under the PSLRA**

2 Scienter is “a mental state embracing intent to deceive, manipulate, or
3 defraud.” *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007)
4 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, and n.12 (1976)). The
5 Private Securities Litigation Reform Act of 1995 (“PSLRA”) created heightened
6 pleading requirements for scienter under Section 10(b) of the Exchange Act:

7 in any private action arising under this chapter in which the
8 plaintiff may recover money damages only on proof that the
9 defendant acted with a particular state of mind, the complaint
10 shall, with respect to each act or omission alleged to violate this
chapter, state with particularity facts giving rise to a ***strong
inference*** that the defendant acted with the required state of
mind.

11 15 U.S.C. § 78u-4(b)(2) (emphasis added).

12 In the Ninth Circuit, the required state of mind is that “the plaintiffs must
13 show that defendants engaged in ‘*knowing*’ or ‘*intentional*’ conduct.” *S. Ferry LP,*
14 *No. 2 v. Killinger*, 542 F.3d 776, 782 (9th Cir. 2008) (*emphasis in original*)
15 (quoting *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975 (9th Cir. 1999)).
16 “[R]eckless conduct can also meet this standard ‘to the extent that it reflects some
17 degree of intentional or conscious misconduct,’ or . . . ‘deliberate recklessness.’”
18 *Id.*; *see also Reese v. Malone*, 747 F.3d 557, 569 (9th Cir. 2014) (same). “To
19 qualify as ‘strong’ . . . an inference of scienter must be more than merely plausible
20

1 or reasonable—it must be cogent and at least as compelling as any opposing
 2 inference of nonfraudulent intent.” *Tellabs*, 551 U.S. at 314.

3 When determining whether Plaintiffs have adequately pled scienter on a
 4 motion to dismiss, the Court must 1) accept all factual allegations as true, 2)
 5 consider the complaint and “other sources courts ordinarily examine when ruling
 6 on Rule 12(b)(6) motions” to determine “whether all of the facts alleged, taken
 7 collectively, give rise to a strong inference of scienter, not whether any individual
 8 allegation, scrutinized in isolation, meets that standard,” and 3) “consider
 9 plausible, nonculpable explanations for the defendant’s conduct, as well as
 10 inferences favoring the plaintiff.” *Tellabs*, 551 U.S. at 322-24. “[T]he court’s job
 11 is not to scrutinize each allegation in isolation but to assess all the allegations
 12 holistically.” *Id.* at 326. “The inference that the defendant acted with scienter need
 13 not be irrefutable, i.e., of the ‘smoking-gun’ genre, or even the ‘most plausible of
 14 competing inferences.’” *Id.* (quoting *Fidel v. Farley*, 392 F.3d 220, 227 (2004)).
 15 Ultimately, “[a] complaint will survive . . . only if a reasonable person would deem
 16 the inference of scienter cogent and at least as compelling as any opposing
 17 inference one could draw from the facts alleged.” *Id.*

18 The Ninth Circuit determined that the Supreme Court’s decision in *Tellabs*
 19 “does not materially alter the particularity requirements for scienter claims
 20 established in [the Ninth Circuit’s] prior decisions, but instead only adds an

1 additional ‘holistic component to those requirements. . . .’ *Zucco Partners, LLC v.*
2 *Digimarc Corp.*, 552 F.3d 981, 987 (9th Cir. 2009). To that end, the Ninth Circuit
3 stated that a court must conduct a dual inquiry when evaluating scienter allegations
4 on a motion to dismiss:

5 First, we will determine whether any of the plaintiff’s
6 allegations, standing alone, are sufficient to create a strong
7 inference of scienter; second, if no individual allegations are
8 sufficient, we will conduct a “holistic” review of the same
9 allegations to determine whether the insufficient allegations
10 combine to create a strong inference of intentional conduct or
11 deliberate recklessness.

12 *Id.* at 992. “When conducting [the] holistic review, however, [the court] must also
13 ‘take into account plausible opposing inferences’ that could weigh against a
14 finding of scienter.” *Id.* at 1006 (quoting *Tellabs*, 551 U.S. at 323).

15 Here, Plaintiffs argue that the small size of Axesstel, the egregiousness of
16 the accounting errors, the relatively large amount of the improperly recognized
17 revenue, and the statements from both Hickock and Gray indicating direct
18 involvement in Axesstel’s sales and collections support a strong inference that
19 Defendants’ knew or were deliberately reckless with regard to the improper
20 recognition of revenue from African Home Alert sales and subsequent statements
as to the collectability of accounts receivable related to the same contracts, and that
therefore the amended complaint adequately alleges scienter. Defendants,

1 meanwhile, contend that the stronger inference from the allegations in the
 2 complaint is that Defendants were not yet aware of the insufficient internal
 3 controls in the sales department that led to the improper revenue recognition and
 4 that the allegations “point more cogently toward the conclusion that Axesstel was
 5 simply overwhelmed with integrating a new product launch into its existing
 6 business.” [Doc. No. 16-1 at 29.] As the Seventh Circuit, faced with similar
 7 competing inferences in *Tellabs* after remand from the Supreme Court, aptly
 8 framed the issue: “The critical question, therefore, is how likely it is that the
 9 allegedly false statements . . . were the result of merely careless mistakes at the
 10 management level based on false information fed it from below, rather than of an
 11 intent to deceive or a reckless indifference to whether the statements were
 12 misleading.” *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 709 (7th
 13 Cir. 2008) (hereinafter, *Tellabs II*).

14 **B. The Amended Complaint Adequately Alleges Scienter**

15 **1. Were Defendants Deliberately Reckless In Failing to** 16 **Obtain Readily Available Information About the** **Home Alert Sales to Africa?**

17 First, Plaintiff argues that Hickock and Gray had access to the relevant
 18 information about the Home Alert sales to Africa and therefore were deliberately
 19 reckless in recognizing revenue in violation of Axesstel’s revenue recognition
 20 policy without reviewing the sales agreements (or lack thereof) of the Home Alert

1 sales to Africa. In the same vein, Plaintiffs argue that Gray was deliberately
2 reckless when he stated in the Q2 2013 SEC filings and on the related investor call
3 that the past due receivables related to these Home Alert sales to Africa were
4 collectible considering Axesstel did not even have final sales contracts.

5 Deliberate recklessness is “a form of intentional or knowing misconduct”
6 such that “the plaintiff must plead ‘a highly unreasonable omission, involving not
7 merely simple, or even inexcusable negligence, but an extreme departure from the
8 standards of ordinary care, and which presents a danger of misleading buyers or
9 sellers that is either known to the defendant or is so obvious that the actor must
10 have been aware of it.’” *Zucco*, 552 F.3d at 991 (quoting *In re Silicon Graphics*
11 *Inc. Securities Litigation*, 183 F.3d 970, 976 (9th Cir.1999)). Notwithstanding this
12 high standard, the amended complaint adequately alleges deliberate recklessness in
13 connection with the alleged false statements here.

14 The SEC filings at issue here, all of which were signed by Hickock, Gray, or
15 both, state that Axesstel only recognized revenue when, among other things, (a)
16 title passed to the customer as specified in the sales agreement, and (b) the price is
17 fixed or determinable. In other words, a minimal prerequisite for Axesstel to
18 recognize revenue is the existence of a final sales agreement with definitive
19 payment terms. There is no dispute here that Axesstel recognized revenue without
20 this bare minimum requirement. Nevertheless, Defendants argue that the amended

1 complaint does not allege scienter because it does not allege that Hickock and Gray
2 actually knew the terms (or lack thereof) of the Home Alert contracts.

3 Defendants essentially argue that the amended complaint does not allege a
4 smoking gun such as a communication to Gray and Hickock stating that no
5 contracts with African customers were finalized. The pleading standard is not so
6 stringent. *Tellabs*, 551 U.S. at 324. *Tellabs* “permits a series of less precise
7 allegations to be read together to meet the PSLRA requirement.” *South Ferry LP*,
8 *No. 2.*, 542 F.3d at 784. Although Defendants are correct that senior executives
9 cannot be expected to know the details of every contract just by virtue of their
10 officer roles, Axesstel is an exceedingly small company and these were no ordinary
11 contracts. The total of five contracts in question accounted for twenty to forty
12 percent of the revenue Axesstel was recognizing in the respective quarters.
13 Moreover, these were supposedly the first contracts for sale of the Home Alert
14 products, and sales that Hickock touted on his calls with investors. Thus, while
15 Hickock and Gray did not have to review every detail of these contracts, it was
16 deliberately and consciously reckless for them to fail to at least confirm that such
17 contracts existed.²

18
19 ² Further, the lack of payment terms related to these sales implies that the sales
20 figures touted by Hickock were little more than estimates, which also supports
scienter, as it would be deliberately reckless to recognize a specific amount of

1 Moreover, the allegations in the amended complaint create a strong
2 inference that Hickock and Gray did in fact know the details of these purported
3 sales. For example, in February 2013, Hickock discussed the reception of the
4 products in Africa and the fact that guards were being trained. Likewise,
5 Hickock's May 2013 statement that minor warranty issues caused a delay in
6 collection on the African contracts infers specific knowledge about the sales,
7 including that they were in fact not final, but contingent on acceptance by the
8 customer.³ Further, on the investor calls, Hickock touted the number of Home
9 Alert contracts to Africa and the amount of revenue attributable to them, while
10 Gray confirmed that "we took a real hard look" at the receivables related to the
11 revenue and found it collectible. To make such statements without even
12 confirming the existence of contracts with set payment terms in place was
13 deliberately reckless and creates a strong inference of scienter.

14
15
16 revenue when the final sales price and payment requirements had not even been
determined.

17 ³ Along these lines, Axesstel's restatement indicates that these warranty issues are
18 what caused the customers not to complete their purchases. [Doc. No. 13 at ¶ 117.]
19 This further supports the inference that based on earlier statements concerning
20 these warranty issues, Hickock and Gray knew all along that these sales were not
final. Yet Axesstel recognized the revenue anyway. At a minimum, this supports
a strong inference of deliberate reckless both about the initial recognition of
revenue, and even more about the collectability of this revenue while these
warranty issues were pending.

2. The Core Operations Theory

Second, Plaintiffs argue that core operations theory creates a strong inference of scienter. Under that theory, the Court “can impute scienter based on the inference that key officers have knowledge of the ‘core operations’ of the company.” *Reese*, 747 F.3d at 575. As the Ninth Circuit explained:

allegations regarding management’s role in a company may be relevant and help to satisfy the PSLRA scienter requirement in three circumstances. First, the allegations may be used in any form along with other allegations that, when read together, raise an inference of scienter that is “cogent and compelling, thus strong in light of other explanations.” This view takes such allegations into account when evaluating all circumstances together. Second, such allegations may independently satisfy the PSLRA where they are particular and suggest that defendants had actual access to the disputed information Finally, such allegations may conceivably satisfy the PSLRA standard in a more bare form, without accompanying particularized allegations, in rare circumstances where the nature of the relevant fact is of such prominence that it would be “absurd” to suggest that management was without knowledge of the matter.

S. Ferry LP, No. 2, 542 F.3d at 785-86 (internal citations omitted).

Here, the amended complaint contains numerous statements from the individual defendants themselves indicating that they were directly involved in sales and knew the details of Axesstel’s dealings with its African customers. As for Hickock, in February 2013, he told investors and analysts that “reception [in Africa] has been fantastic.” Between February and May 2013, Hickock spent four

1 weeks meeting with customers and logistic partners in Africa. Further, in a June
 2 2013 press release, Axesstel announced that Hickock would be taking over the
 3 responsibilities of Chief Marketing Officer and had “been increasingly active in
 4 key customer relationships.”⁴ *Cf. Daou*, 411 F.3d at 1022 (“[S]pecific admissions
 5 from top executives that they are involved in every detail of the company and that
 6 they monitored portions of the company’s database are factors in favor of inferring
 7 scienter in light of improper accounting reports”). As for Gray, his assurance that
 8 the accounts receivable had been reviewed for collectability necessarily implies
 9 confirmation that the contracts supporting such sales at least existed and were
 10 available for review, which according to the amended complaint was not the case.⁵

11 In addition to these specific allegations creating an inference of the
 12 individual defendants’ scienter, the amount of the falsely recognized revenue,
 13 which came from only a handful of contracts and signified the first sales of a major

14 ⁴ The amended complaint also contains allegations about Hickock’s involvement in
 15 sales and marketing based on the statements of a confidential witness. Because the
 16 other allegations in the amended complaint are sufficient to satisfy the PSLRA’s
 scienter requirements, the Court did not consider or rely on the confidential witness
 allegations for this opinion.

17 ⁵ Defendants argue that Gray’s failure to discover that the contracts did not exist
 18 when reviewing the collectability of the accounts receivable is not evidence of
 19 fraud. This argument is not persuasive. If Gray did not discover the lack of
 20 payment terms for these receivables, his statement that he took a “real hard look”
 was false and deliberately reckless because no “real hard look” would miss this
 fact. If Gray did in fact discover the lack of payment terms or contract, then his
 reassurance that the receivables were collectable was false and deliberately
 reckless.

1 new product for Axesstel, creates a strong inference that Hickock and Gray would
2 be aware of the details of these sales. *See Berson v. Applied Signal Tech., Inc.*, 527
3 F.3d 982, 988 n.5 (9th Cir. 2008) (“The size of the contract and the prominence of
4 the client raise a strong inference that defendants would be aware of this order.”);
5 *see also Curry v. Hansen Medical, Inc.*, No. C 09-5094 CW, 2012 WL 3242447, at
6 *11 (N.D. Cal. Aug. 10, 2012) (stating that because defendant was small company
7 with less than 200 employees and sold so few units, each of which was significant
8 to its revenue stream, the individual defendants must have known about each of the
9 sales).

10 Further, Hickock’s and Gray’s roles in Axesstel are magnified by the
11 exceedingly small size of the company. Axesstel is not to be confused with Apple.
12 The individual defendants here are not officers in a large company who “may be
13 removed from the details of a specific business line or remote business activity.”
14 *Reese*, 747 F.3d at 572. Rather, Axesstel has only thirty-five employees, including
15 only six employees in executive or administrative roles. Thus, the individual
16 defendants would be among the first (and only) to know of the details of major
17 contracts, or conversely as is alleged here, that products were being shipped
18 despite the fact that no such contracts had been signed. *Cf. Batwin v. Occam*
19 *Networks, Inc.*, No. CV 07-2750 CAS (SHx), 2008 WL 2676364, at *12 (C.D. Cal.

1 July 1, 2008) (factoring the company's relatively small size, with 80-100
 2 employees, in finding allegations of scienter to be persuasive).

3 In sum, it would be absurd to think that the CEO and CFO of a company
 4 with just thirty-five employees, of whom only ten are involved in sales, general or
 5 administration, would be unaware of the lack of written agreements or definitive
 6 payment terms with the five new customers in Africa that represented the
 7 company's first sales of a significant new product that constituted between twenty
 8 and forty percent of Axesstel's overall revenue. *See Berson*, 527 F.3d at 989 (9th
 9 Cir. 2008) (holding that complaint alleged scienter when the complaint alleged
 10 facts supporting an inference that the statements were misleading when made and
 11 that the facts were prominent enough that it would be "absurd to suggest" that top
 12 management was unaware of them).

13 With respect to Hickock, this absurdity is compounded in light of his
 14 specific involvement in Axesstel's sales. *Cf. In re InfoSonics Corp. Sec. Litig.*, No.
 15 06cv1231 BTM(WMc), 2007 WL 2301757, at * (S.D. Cal. Aug. 7, 2007) (noting
 16 that a high-level employee in sales at a company with fewer than thirty employees
 17 would be in a position to know about problems with the company's biggest
 18 customer). Indeed, both Hickock and Gray made statements about a "minor
 19 warranty issue" related to the Home Alert products in Africa. [Doc. No. 13 at ¶¶
 20 48-50.] That these executives were aware of an issue even they deemed minor

1 creates a strong inference that they would also be aware of the major issue that no
 2 contracts or payment terms were actually in place for the sale of those products.
 3 Likewise, it would be absurd to suggest that Gray could have taken (or even
 4 supervised) a “real hard look” at receivables related to the African sales without
 5 discovering (to the extent he did not already know) that the agreements for such
 6 sales were at most verbal, and more significantly, *lacked payment terms*. Cf.
 7 *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1234 (9th
 8 Cir. 2004) (holding that complaint alleged scienter of top Oracle executives in part
 9 because of allegations of specific admissions from top management concerning
 10 their involvement in the business and the magnitude of the allegedly improper
 11 revenue recognition)

12 Accordingly, in light of the foregoing, the allegations in the amended
 13 complaint concerning Hickock’s and Gray’s respective roles in Axesstel both
 14 generally and with respect to the sales at issue here satisfy the PSLRA’s
 15 requirement of a strong inference of scienter.

16 **3. Holistic Review and Competing Inferences**

17 Even if the previously discussed individual allegations were not enough on
 18 their own to support a strong inference of scienter, a holistic review of these
 19 allegations along with all of the other allegations in the amended complaint creates
 20

1 a cogent inference of scienter that is more compelling than any of the alternative
2 inferences argued by Defendants. *Tellabs*, 551 U.S. at 322-24.

3 Defendants' argue that "it is more cogent and compelling to infer that
4 Axesstel's management, acting in good faith, was unable to immediately identify
5 and effectively control the internal control and accounting processes within the
6 Company during its product launch with new customers in a new geographic
7 region, than that it was intentionally and systematically manipulating its
8 accounting records to make the Company seem more successful shortly before
9 voluntarily announcing the need to restate." [Doc. No. 21 at 14.] This argument
10 implies that the restatement here is merely a correction of minor technical
11 accounting issue, which simply is not the case.

12 In addition to all of the scienter allegations discussed above, the amended
13 complaint alleges with particularity that Defendants violated simple GAAP
14 accounting principles along with Axesstel's own revenue recognition policy to
15 prematurely recognize millions of dollars in revenue, equaling 22.2% of its
16 revenue in Q4 2012, and almost 40% of its revenue in Q1 2013.⁶ "Certainly,

17
18 ⁶ Limiting the calculations to Axesstel's Home Alert product further strengthens
19 the inference of scienter. Axesstel, through filings and other statements signed or
20 made by Hickock and Gray, announced \$7.5 million in Home Alert sales in Q4
2012 and Q1 2013. According to the amended complaint, none of these sales were
final and in fact all of the shipped product was returned. In other words, Axesstel,
through Hickock and Gray, announced \$7.5 million in Home Alert sales when the

1 prematurely recognizing millions of dollars in revenue is not minor or technical in
 2 nature.” *Daou Sys., Inc.*, 411 F.3d at 1020 (noting that the complaint alleged that
 3 48% of the company’s reported revenue was prematurely recognized). Moreover,
 4 “while scienter cannot be established by publishing inaccurate accounting figures,
 5 even when in violation of GAAP . . . significant violations of GAAP standards can
 6 provide evidence of scienter so long as they are pled with particularity.” *Daou*
 7 *Sys., Inc.*, 411 F.3d at 1022; *cf. In re McKesson HBOC, Inc. Sec. Litig.*, 126
 8 F.Supp. 2d 1248, 1273 (N.D.Cal.2000) (“When significant GAAP violations are
 9 described with particularity in the complaint, they may provide powerful indirect
 10 evidence of scienter. After all, books do not cook themselves.”). Here, it strains
 11 credulity to believe that Hickock and Gray did not know that no final contracts in
 12 fact existed for the Home Alert sales in Africa, when such sales purportedly
 13 equaled between 20% and 40% of Axesstel’s overall quarterly revenue and 100%

14 actual amount of sales was zero. Viewed through this lens, the allegations in the
 15 amended complaint are similar to a hypothetical from *Tellabs II* used to explain
 16 how it is possible to create a strong inference of corporate scienter even if it was
 17 unknown what individuals were responsible for dissemination of the false
 18 information: “Suppose General Motors announced that it had sold one million
 19 SUVs in 2006, and the actual number was zero. There would be a strong inference
 20 of corporate scienter, since so dramatic an announcement would have been
 approved by corporate officials sufficiently knowledgeable about the company to
 know that the announcement was false.” *Tellabs II*, 513 F.3d at 710; *see also*
Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 744 (9th Cir. 2008) (noting
 that “there could be circumstances in which a company’s public statements were so
 important and so dramatically false that they would create a strong inference that at
 least some corporate officials knew of the falsity upon publication”).

1 of its revenue from its important new product. *See Brown v. China Integrated*
2 *Energy, Inc.*, 875 F.Supp. 2d 1096, 1123 (C.D. Cal. 2012) (“It strains credulity to
3 believe that [the defendant’s] directors and officers did not know that a factory that
4 . . . generated 20% of total company sales was not functioning.”).

5 Nor is Defendants’ argument that their voluntary restatement weighs against
6 scienter compelling. That Defendants came clean when Axesstel’s cash position
7 was so poor that they likely had no other choice does not lead to a compelling
8 inference that the individual defendants did not know all along that these purported
9 sales to Africa were not finalized. The fact that Defendants’ gamble—recognizing
10 revenue and vouching for the collectability of that revenue in the absence of
11 contracts with payment terms in the hopes that the customers will ultimately agree
12 to purchase the products—“fails is not inconsistent with its having been a
13 considered, though because of the risk a reckless, gamble. It is like embezzling in
14 the hope that winning at the track will enable the embezzled funds to be replaced
15 before they are discovered to be missing.” *Tellabs II*, 513 F.3d at 710.

16 Ultimately, while it is conceivable that the CEO and CFO of a thirty-five
17 person company could be completely unaware of the fact that there were no written
18 contracts for the sale of \$7.5 million of their company’s new product that had been
19 shipped to Africa, this possibility is exceedingly unlikely, and more important to
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1 this instant analysis, a less compelling inference than the compelling inference of
 2 scienter based on a holistic review of the allegations in the amended complaint.

3 Accordingly, given the size of Axesstel, Hickock's and Gray's management
 4 roles in Axesstel and their alleged involvement in sales and the complete lack of
 5 contracts for the purported sales of Home Alert products in Africa at issue here, the
 6 egregious nature GAAP violations, and the amount of the improperly recognized
 7 revenue, there is a logical, and strong, inference that Defendants were aware at the
 8 time the false statements were made that the revenue was being recognized
 9 improperly. Moreover, this inference is far more compelling than Defendants'
 10 hypothesis that the false statements were merely the result of being overwhelmed
 11 with a new product launch.

12 **C. Section 20(a)**

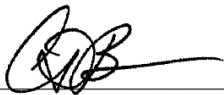
13 Plaintiffs' claim under Section 20(a) of the Exchange Act requires "(1) a
 14 primary violation of federal securities law, and (2) that the defendant exercised
 15 actual power or control over the primary violator." *Howard v. Everex Sys.*, 228
 16 F.3d 1057, 1065 (9th Cir. 2000). Axesstel's motion to dismiss this claim is
 17 predicated entirely on its argument that the amended complaint fails to state a
 18 primary violation of Section 10(b) for failure to adequately allege scienter. Thus,
 19 because the Court finds that the amended complaint pleads a strong inference of
 20

1 scienter for purposes of establishing a primary violation of Section 10(b), the
2 motion to dismiss the Section 20(a) claim fails.

3 **IV. Conclusion**

4 For the foregoing reasons, Defendants' motion to dismiss is **DENIED**. It is
5 **SO ORDERED**.

6 Dated: February 13, 2015

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8 Hon. Cathy Ann Bencivengo
9 United States District Judge
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